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January 15, 2003

Ms. Marlene Dortch
Secretary
Federal Communications Commission
445 12th Street, SW, Room TWB-204
Washington, DC 20554

Re: Notice of Written Ex Parte Communication, In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, CC Docket Nos. 01-338, 96-98 and 98-147

Dear Ms. Dortch:

This letter responds to SBC's December 11, 2002 *Ex Parte* in the above captioned dockets.¹ In that filing, SBC mounts a last-ditch campaign to salvage its "transition plan" in which SBC would offer competitive carriers "the functional equivalent of UNE-P" for two years at a price of \$26 per month.² SBC's letter only makes plain that its proposal is the sleeves off its vest, because the proposed rate is substantially above any reasonable assessment of SBC's cost and would not permit meaningful competition for mass market customers. Accordingly, the Commission should instead reaffirm that competitors are entitled to UNE-P at cost-based rates.

¹ See December 11, 2002 *Ex Parte* Letter from James Smith (SBC) to Marlene Dortch ("December 11, 2002 SBC *Ex Parte*"). In commenting on WorldCom's recent impairment model, SBC makes claims similar to those contained in the December 11, 2002 SBC *Ex Parte* suggesting that profitability analyses should focus exclusively on the highest-revenue customer segment and consider long distance and other revenues in assessing the ability of competitive carriers to enter profitably local markets and determine "impairment." Thus, this letter responds to these claims as well.

² *Id.* at 1.

1. Relying on data from undocumented sources, SBC claims that if all possible revenue sources are considered, its UNE-P offer would provide sufficient “margins” for competitive carriers to compete for some “high end” customers. But this claim does *not* answer the central economic and policy question posed in these proceedings. Competitive carriers simply cannot be expected to enter local markets where the incumbent has an “absolute cost advantage” relative to the entrant, regardless of what prices currently prevail in the market (and, therefore, what “margins” may currently exist).³ As Professor Willig has explained, where a competitive carrier must incur significantly higher costs to provide local services, an incumbent carrier can respond to entry by dropping prices below the competitive carrier’s costs.⁴ Such a pricing strategy will still allow the lower-cost incumbent to remain profitable; but by setting prices below the entrant’s costs, the incumbent would make it impossible for the entrant to remain economically viable.⁵

Entry under these conditions would surely create “competition” that is merely synthetic, and viable only at the incumbent’s sufferance. And that is why the Act requires network elements to be priced at levels that reflect *the incumbent’s economic cost* of providing those elements.⁶ Indeed, the Commission’s *Local Competition Order* expressly and properly rejected the efficient component pricing rule (“ECPR”) as a permissible pricing rule for UNEs because it focuses on margins (in this case, the incumbent’s) rather than costs in setting prices.⁷ The wisdom of this decision by the Commission was affirmed by the Supreme Court.⁸

The reason SBC does not even attempt to show that its proposed “transition” rate is cost-based is simple: any such effort would be futile. The proposed \$26 per month charge is well in excess of the TELRIC-based rates that the state commissions have set for UNE-P in the SBC states.⁹ Competition on the merits is simply not possible when competitive

³ Jean Tirole, *THE THEORY OF INDUSTRIAL ORGANIZATION* 306 (1988). This is not to say that a demonstration that margins are negative would be economically irrelevant. Clearly, even if competitive carriers could enter at a cost comparable to the incumbents’ costs, entry will not occur if existing retail rates do not permit them to earn a reasonable return.

⁴ See November 14, 2002 *Ex Parte* Letter from C. Frederick Beckner III to Marlene Dortch (attaching Robert D. Willig, “Determining ‘Impairment’ Using the *Horizontal Merger Guidelines*’ Entry Analysis”).

⁵ See Richard Gilbert, *Mobility Barriers and the Value of Incumbency*, in *I HANDBOOK OF INDUSTRIAL ORGANIZATION* 493 (Richard Schmalensee and Robert Willig, eds. 1989) (“If a potential entrant has a cost disadvantage with respect to an established firm, this is a factor that can allow the established firm to maintain a price above cost.”). See also, note 13, *infra*.

⁶ See *Local Competition Order*, 11 FCC Rcd. 15499, ¶ 679 (1996).

⁷ See *id.* ¶¶ 708-711. The Commission has been clear on this point: “Congress specifically determined that input prices should be based on costs because this would foster competition in the retail market. Therefore we reject the use of ECPR for establishing prices for interconnection and unbundled elements.” *Id.* ¶ 710.

⁸ *Verizon Communications Inc. v. FCC*, 122 S. Ct. 1646, 1674 n.27 (2002) (finding the Commission’s decision to reject ECPR was reasonable “because [ECPR’s] calculation of opportunity cost relied on existing retail prices in monopolistic local-exchange markets, which bore no relation to efficient marginal cost.”).

⁹ See September 25, 2002 *Ex Parte* Letter from Joan Marsh to Marlene Dortch (state commissions in SBC states have, on average, priced residential UNE-P at \$16.07 per month).

carriers must pay over *60 percent more* than the costs SBC incurs for obtaining access to the network facilities necessary to provide local telecommunications services.

2. But even assuming that existing local service margins were to be the basis for UNE pricing, SBC's margin analysis proceeds from a fundamentally flawed premise. SBC says that the relevant benchmark for margin analysis should be the potentially most profitable local customers, rather than the "average" customer, as used in AT&T's November 21, 2002 *ex parte*.¹⁰ Thus, implicit in SBC's position is that its \$26 offer is reasonable *even if it does not permit competitive carriers to compete for the majority of customers*.

This proposition is directly contrary to the fundamental purpose of the Act. Congress intended to open local markets for "All Americans," not just the small fraction of customers that are the most intensive users of telecommunications services.¹¹ Indeed, taken to its logical extreme, SBC's position is that it would be lawful for a monopolist to foreclose competitors from the lion's share of a market so long as competitors could reach a handful of customers. Of course, established precedent holds that foreclosure of a significant percentage of customers violates the antitrust laws.¹² And as the D.C. Circuit recently held, it is against the "public interest" for the Commission to permit any price squeeze that "exert[s] *any* anticompetitive effects," even if it does not "*absolutely* preclude" competition.¹³ Accordingly, above-cost UNE-P rates such as those proposed by SBC – rates that do not permit competition for typical subscribers – should be rejected out of hand.

Indeed, data available from TNS Telecoms Bill Harvesting database conclusively show that SBC's offer would not allow competitive carriers the ability to compete for *most* customers. SBC suggests that competitive carriers can afford to pay \$26 per month for UNE-P because they have the ability to earn local plus long distance revenues in the range of \$48 to \$68 per month.¹⁴ Although such revenues may be potentially available from some customers, according to the TNS data, *less than 19 percent* of all residence lines generate local plus long distance revenues of \$48 or greater, and *less than 7 percent* generate local plus long distance revenues of \$68 or greater.¹⁵ Thus, even using SBC's

¹⁰ See December 11, 2002 SBC *Ex Parte* at 5-6 (arguing that AT&T's prior margin calculations are flawed because they are based on "average local revenues across [the] entire residential customer base" instead of "high valued customers").

¹¹ Conference Report, 104th Cong. 2d Session, Report 104-458.

¹² See ANTITRUST LAW DEVELOPMENTS (Third) 177 (1992).

¹³ *WorldCom Inc. v. FCC*, 308 F.3d 1, 10 (D.C. Cir. 2002) (quoting *Anaheim v. FERC*, 941 F.2d 1234, 1238 (D.C. Cir. 1991)) (emphasis in original).

¹⁴ As explained herein, in assuming entry is profitable when competitive carriers can earn local and long distance revenues of \$48 to \$68 per month, SBC simply ignores the additional costs competitive carriers incur to provide long distance, and it understates the total SG&A costs that a competitive carrier must incur.

¹⁵ Elsewhere in its advocacy, SBC has questioned the validity of TNS data and intimated that its own confidential data show more generous levels of customer revenue. Such undocumented assertions should be granted no weight. Expenditure data from TNS Telecoms are widely accepted as valid throughout the

own figures about profitability at these revenue levels, SBC's \$26 offer would clearly prevent competition for the vast majority of customers.

SBC is also wrong that competitive carriers are only interested in cherry-picking and have no interest in attracting a broad customer base. As an initial matter, competitive carriers incur substantial marketing costs when they enter a local market. These marketing efforts reach *all* classes of customers, not just "high volume" subscribers. If these costs can be amortized only against a small subset of high-volume customers, local entry becomes less profitable. In essence, SBC's argument is that competitive carriers should spend money to plow and plant the whole field, but recover these costs only through sale of the best individual ears in the crop. That is clearly not the intent of the Act. Rather, it is to assure a marketplace in which competitors have access to UNEs at efficient cost-based prices until they can provide their end user services using inputs from alternative sources in a similarly efficient manner. Subjecting competitors to excessively high costs that preclude them from serving most customers is neither consistent with the Act's requirements or economically rational, and it also does absolutely nothing to encourage new investment.

Further, many of the costs of entering local markets are fixed. As such, these costs cannot be recovered by serving only a handful of customers. Rather, these sizeable fixed costs can only be recovered if competitive carriers can spread those costs over a sizeable customer base.

Contrary to SBC's claims of CLEC cherry-picking, the facts do not support its theory. SBC says that AT&T is targeting only high-end customers based solely on the fact that, for Texas, the most "basic" local services package it finds AT&T to be promoting on its web site is a package costing \$25 per month (and gives customers unlimited local services and three features).¹⁶ This argument does not even pass the straight-face test. SBC concedes that AT&T does in fact *offer* a service for the "low end" customer, but claims that it is effectively unavailable because it is not promoted on AT&T's web site.¹⁷ But AT&T's web site is not AT&T's principal (or even very significant) marketing and customer acquisition tool. Rather, AT&T relies most heavily on media advertising. Thus, although AT&T's web site promotes its more premium services – which makes perfect sense given that customers that purchase services over the Internet tend to want such services¹⁸ – it uses its major marketing channels to promote the "lower" level services that SBC concedes that AT&T offers. Indeed, a perusal of SBC's residential service websites

telecommunications industry. The Commission references these data in its own reports on the status of telecommunications markets, and they are subscribed to and/or referenced by many of the largest incumbent local exchange and interexchange carriers in the industry. *See, e.g.*, <http://newscenter.verizon.com/proactive/newsroom/release.vtml?id=78494> (Verizon's referring to TNS data in support of its announcement that it is now the country's third-largest long distance carrier).

¹⁶ *Id.* at 6 & n.25.

¹⁷ *Id.* at 6.

¹⁸ AT&T is not alone in this regard. SBC's web site also heavily promotes its most feature rich (and expensive) local offerings in Texas. *See* http://www01.sbc.com/Products_Services/Residential/Catalog/1,1965,-6-3-,00.html.

reveals that they generally are devoid of any mention of the *possibility* that a customer can order just basic local service.¹⁹

And because AT&T and other competitive carriers generally enter markets when UNE-P is priced at a level that permits broad-based entry, the customer base of competitive carriers is not radically different from that of the incumbent carriers. As a threshold matter, SBC has filed data with the Commission that confirms that urban, suburban and rural zone UNE-P customers are won by CLECs in the about the proportions as these customers exist generally.²⁰ Further, the customers that CLECs do win are not “creamier” than the population average. TNS Telecoms collects residential bill data from both incumbent and competitive carrier customers. In Michigan, the SBC state where competitive carrier penetration may be the most advanced due to effective State UNE-P policies, bills from 2001 through the third quarter of 2002 show that households taking competitive carrier service have slightly *lower* local plus long distance telecom expenditures than households taking SBC’s service. And given the lack of verifiable contradicting data, SBC’s claim that competitive carriers target only the highest end customers and that incumbents are left disproportionately with low end customers should be rejected out of hand.

3. SBC also asserts that AT&T’s margin analysis ignores the revenues that carriers can earn from exchange access and long distance services.²¹ As to the former, SBC’s claim is puzzling. AT&T in fact included *all* relevant exchange access revenues in its margin analysis, including both the direct benefit of collecting terminating access charges and the indirect benefit of avoiding originating access. These revenue sources were included under the heading “Access” in Attachment 1 to AT&T’s November 21, 2002 *ex parte*.

¹⁹ See, e.g., http://www05.sbc.com/Products_Services/Residential/Catalog/1,,0--10-3-0,00.html . Indeed, the SBC web site seems intended to mislead customers because it claims to show “All products and services.”

²⁰ See November 26, 2002 *Ex Parte* Letter from Joan Marsh to Marlene Dortch (demonstrating that zone-by-zone UNE-P data submitted *ex parte* by SBC on October 30, 2002 match residential zone distributions in the general population).

²¹ December 11, 2002 SBC *Ex Parte* at 3-5. SBC also claims that AT&T underestimated available subsidies, but provides no explanation or citation for its position that “on average” a local carrier collects such subsidies in the amount of \$1.25 per customer per month. It is possible that SBC is confused between subsidy fund collections and subsidy fund support disbursements. The former is the amount that SBC collects through line item charges on its end user bills (e.g., FCC Universal Service Fund charge). But these amounts are simply passed through to fund administrators (e.g., USAC), they are not kept as “revenue” by SBC any more than are the sales taxes that may be added on to SBC end user bills. The subsidy monies that may be kept as revenue by SBC are the disbursements it receives from subsidy fund administrators. It is only these latter figures that may be considered as “revenue” for margin analysis purposes. Because SBC fails to provide any detail behind its allegation that incumbent subsidy receipts are \$1.25, AT&T cannot further explain the source of SBC’s misapprehension.

As to the long distance services, SBC is simply wrong on the economics when it contends that *all* of the long distance revenues that a competitive carrier earns should be included in the margin analysis.²² As an initial matter, competitive carriers such as AT&T generally earn no incremental long distance services from providing local services. That is because the lion's share of their local customers are *existing* interLATA long distance subscribers. In such situations, by definition, there is no additional long distance revenue opportunity gained from providing local.

Further, even where it could be said that a local provider earns incremental revenues from offering long distance services, it also incurs incremental *costs*. In SBC's topsy-turvy margin analysis, however, none of the costs of long distance are reflected. This is no small omission. Long distance is intensely competitive and, as basic economics teaches, in fully competitive markets revenues converge towards incremental costs (including an appropriate return on capital). Thus, accounting for long distance would make little difference to a properly conducted margin analysis.

And just as fundamentally, even if long distance carriers were somehow earning large margins, it simply makes no sense to assume that they would use those margins to offset local entry that is unprofitable in its own right. All that would do is reduce the overall level of profits earned by the carrier.²³

4. Finally, SBC complains that AT&T overstates SG&A costs in its prior margin analysis.²⁴ Tellingly, while nitpicking the methodology AT&T used to determine the SG&A cost in its calculations, SBC does not actually claim that this number is excessive. Nor could it. AT&T has come forward with substantial testimony confirming the conservativeness of using SBC's \$9.60 figure. Specifically, in the Qwest section 271 proceedings, AT&T sponsored the testimony of Arthur Menko who examined the internal retail costs of other telephone and cable carriers. Mr. Menko found that these providers uniformly had internal retail costs in excess of \$10 per month, with some companies having costs as high as \$20 per month.²⁵ Further, in that same proceeding and many others, AT&T has submitted a declaration sponsored by Steven Bickley that states that AT&T's internal cost is also in excess of \$10 per line per month. In light of SBC's failure to offer any hard evidence in rebuttal, \$9.60 must be considered a minimum estimate.

²² *Id.* at 4.

²³ SBC in passing complains that AT&T ignored intraLATA toll revenues. December 11, 2002 SBC *Ex Parte* at 4. Again, in most jurisdictions, UNE-P only provides the exchange access portion of intraLATA toll calls and additional facilities are employed for the long haul portion of the call. As discussed, AT&T already includes exchange access revenues in its calculations. Further, as discussed, the substantial costs of these facilities would have to be subtracted from the toll revenues.

²⁴ *Id.* at 7-8.

²⁵ November 12, 2002 *Ex Parte* Letter from Alan Geolot to Marlene Dortch, WC Docket No. 02-314 (attaching Declaration of Arthur S. Menko).

Consistent with Commission rules, I am filing one electronic copy of this notice and request that you place it in the record of the above-referenced proceedings.

Sincerely,

A handwritten signature in black ink, appearing to be 'JM', with a long horizontal line extending to the right.

Joan Marsh

cc: William Maher
Jeff Carlisle
Michelle Carey
Brent Olson
Rich Lerner
Scott Bergmann
Thomas Navin
Jeremy Miller